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Whether "hedging" anticipated contingency fees should be deemed impermissible fee-sharing under section 504 when the policy considerations underlying the statute are not offended

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INTRODUCTION

Although the Bankruptcy Code establishes a clear prohibition against the sharing of fees by persons receiving compensation or reimbursement under section 504, it is unclear whether bankruptcy attorneys may be permitted to enter into "hedging" arrangements in order to obtain downside protection against risks associated with appeal. Ultimately, what is needed to decide this issue is a determination of what constitutes "sharing" of compensation within the meaning of the Code. Recently, in *In re Winstar Communications, Inc.*, 378 B.R. 756 (Bankr. D. Del. 2007), the bankruptcy court found no ambiguity in the statute, and gave the term "sharing" its plain meaning, when it rejected a proposed hedge transaction between attorneys retained by a Chapter 7 Trustee and a lending institution. *Id.* at 761. This memorandum will argue that the proposed hedge transaction should have been allowed because latent ambiguity exists in the term "sharing," and because the proposed agreement did not appear to offend the policy considerations underlying section 504. Part I of this memorandum describes fee sharing generally under section 504, including the policy considerations underlying the prohibition against fee-sharing, as well as the leading cases that have addressed the issue in the context of professional ethics. Part II examines judicial treatment of section 504, providing examples of

impermissible fee-sharing arrangements, as well as fee arrangements that have been allowed. Part III focuses on *In re Winstar*, how the court came to its conclusion, and why the court's reasoning is flawed. This memorandum concludes with a discussion of the impact that *In re Winstar* may have on the larger context of bankruptcy law, professional ethics and compensation.

I. Fee-Sharing Under Section 504

In order to understand the prohibition against fee-sharing, and more importantly the purpose of the a prohibition, one must first look to section 504 of the Bankruptcy Code. Fee sharing among attorneys is generally prohibited unless the relationship falls within one of the narrow exceptions provided by section 504. *See In re Greer*, 271 B.R. 426, 430 (Bankr. D. Mass. 2002). Specifically, section 504(a) states that "a person receiving compensation or reimbursement under section 503(b)(2) or 503(b)(4) of this title may not share or agree to share—(1) any such compensation or reimbursement with another person; or (2) any compensation or reimbursement received by another person under such sections." 11 U.S.C. §504 (2006). Section 503(b)(2) allows the administrative expenses for compensation under section 330(a), which provides for the compensation of a trustee, examiner or the trustee's (or debtor in possession's) and committee's professionals employed under sections 327 or 1103, as well as reimbursement of their expenses. *See* 11 U.S.C. §330 (2006). Section 503(b)(4) allows administrative expenses for the reasonable compensation for legal or accounting services rendered to a person whose expense is allowed under section 503(b)(3), a provision generally allowing expenses for creditors making substantial contributions to the estate, and the expenses on committee members. *See* 11 U.S.C. §503 (2006). The two limited exceptions are provided

under section 504(b), which applies only to members, partners, or regular associates in a professional association, corporation, or partnership, and to attorneys contributing to the services rendered or expenses incurred by a creditor's attorney that files an involuntary petition under section 303. *Id.*

Due to the lack of legislative history on section 504, judicial opinions discussing the issue of fee-sharing provide the best indication of the purpose behind the prohibition. The Supreme Court has long recognized the obvious dangers of sharing compensation in a bankruptcy case. Specifically, the Court has noted that agreements to share compensation are no less objectionable merely because they do not result in a detriment to the estate, and the potential for harm makes such arrangements reprehensible as a matter of public policy as well as a violation of the attorney's ethical obligations. *See Well v. Neary*, 278 U.S. 160, 173–74 (1929). By enacting section 504, "Congress sought to generally prohibit the sharing of compensation or fee splitting among attorneys in a bankruptcy case." *In re Warner*, 141 B.R. 762, 765–66 (M.D. Fla. 1992) (citing *In re Matis*, 73 B.R. 228, 231 (Bankr. N.D.N.Y. 1987)). Moreover, courts have described the purpose of section 504 as the preservation of "the integrity of the bankruptcy process so that the professionals engaged in bankruptcy cases attend to their duty as officers of the bankruptcy court, rather than treat their interest in bankruptcy cases as 'matters of traffic.'" *See Matter of Arlan's Department Stores, Inc.*, 615 F.2d 925, 943–44 (2d Cir. 1979).

Courts have noted two important policy considerations underlying section 504. First, whenever fees or other compensation are shared among two or more professionals, there is incentive to adjust upward the compensation sought in order to offset any diminution to one's own share, which can inflate the cost of a bankruptcy case to the debtor and therefore to the creditors. *See In re Worldwide Direct, Inc.*, 316 B.R. 637, 649 (Bankr. D. Del. 2004) (quoting *In*

re Peterson, No. 04 2004 WL 1895201 at *4 (Bankr. D. Idaho 2004)). Second, fee sharing subjects the professional to outside influences over which the court has no control, which tends to transfer from the court some degree of power over expenditure and allowances. *See In re Futoronics Corp.*, 655 F.2d 463, 470 (2d Cir. 1981), *cert. denied*, 455 U.S. 941, 102 (1982).

The leading cases addressing the prohibition against fee-sharing under section 504, including its statutory and common law predecessors, have focused on the role of attorneys in the context of professional ethics. *See* 4 COLLIER ON BANKRUPTCY, ¶ 504, at 504–15 (Alan N. Resnick et al. eds., 14th ed. rev. 2007). For example, in *Matter of Arlan's Department Stores, Inc.*, 615 F.2d 925 (2d Cir. 1979), the debtor-in-possession was a retail discount store chain represented by two law firms acting as general and special counsel, in Chapter 11 proceedings. The lower court found that the firm acting as general counsel breached its fiduciary obligations to the court by failing to disclose prior representation, a letter agreement with another party of interest to the proceedings, and receipt of retainer fees. Accordingly, the lower court denied fees and disbursements, and ordered the return of money already paid to them plus interest. *Id.* at 929. On appeal, the Second Circuit affirmed this judgment, recognizing that "counsel for the debtor is an officer of the court and is bound by fiduciary standards." *Id.* at 932 (citing *Brown v. Gerdes*, 321 U.S. 178, 182 (1944); *Finn v. Childs Co.*, 181 F.2d 431, 441 (2d Cir. 1950) ("in all cases persons who seek compensation for services or reimbursement for expenses are held to fiduciary standards")). Noting that the debtor's attorneys had flatly denied being a fiduciary, the Second Circuit stated that this "position is untenable and it is indeed shocking that experienced bankruptcy attorneys would consider their relationship to the court or the estate of the debtor in such a light." *Id.*

The relationship between the fiduciary duties of attorneys and compensation in the context of bankruptcy proceedings was also addressed in *Matter of Futuronics Corporation*, 5 B.R. 489 (S.D.N.Y. 1980), *aff'd*, 655 F.2d 463 (2d Cir. 1981). A law firm retained as debtor's counsel in a bankruptcy proceeding had sought to retain special counsel to pursue claims that government contracts were wrongfully terminated. The bankruptcy court rejected a proposed retention order calling for special counsel to pay one-third of all fees to the debtor's counsel. Years later, it was revealed that special counsel has paid over $60,000 in fees to the debtor's counsel, despite numerous inquiries made by the court regarding the fee arrangement between the attorneys. The district court described such conduct as "totally unprofessional and in breach of their respective duties as fiduciaries and officers of the court." *Id.* at 499. Accordingly, the attorneys were ordered to pay to the debtor all fees collected plus interest, and were denied any further compensation. The district court noted that attorneys are officers of the court and must conduct themselves accordingly. "They are professionals and, as such, are to be held to a higher standard in the discharge of their duties in this regard." *Id.* at 491 (citing *Matter of Arlan's Department Stores, Inc.*, 615 F.2d 925 (2d Cir. 1970). On appeal, the Second Circuit affirmed the district court, concluding that "given the egregiousness of the conduct here, it was an abuse of discretion to permit the appellants to retain any of the fees they had received, let alone to allow any further compensation." *In re Futuronics Corp.*, 655 F.2d 463, 471 (2d Cir. 1981).

II. Judicial Treatment of Fee-Sharing

Findings of improper fee sharing under section 504 can be fairly simple depending on the facts of each particular case. For example, in *In re Codesco*, a secured creditor in a Chapter 11 proceeding objected to applications for allowances made by accountants and an appraiser

retained by the debtor. 15 B.R. 351 (Bankr. S.D.N.Y. 1981). Without the court's approval, the appraiser agreed to pay an outside consultant from the compensation received from the debtor. *Id.* at 353. The court held that the appraiser's failure to disclose the fee arrangement constituted a violation of section 504. *Id.* Similarly, in *In re Anderson*, the debtor's attorney hired his son to assist in the prosecution of various suits and other matters in the bankruptcy proceedings, even though this separate employment was not authorized by the court at that time. 936 F.2d 199 (5th Cir. 1991). Although the son was also an attorney, the two attorneys did not practice law together. *Id.* at 201. The son was paid at $10,000 retainer. Id. The Fifth Circuit affirmed the bankruptcy court's partial denial of the son's fee application, and concluded that even if the son was paid from the father's funds rather than from the estate, such compensation would have been in violation of section 504. *Id.* at 203. Lastly, in *In re Larsen*, the debtor's attorney contracted out a court appearance to another attorney who was not associated with the debtor attorney's firm. 190 B.R. 713 (Bankr. D. Me. 1996). The bankruptcy court refused the attorney's expense reimbursement request, finding that such an arrangement represented an impermissible and undisclosed sharing of compensation in violation of the rules. *Id.* at 718.

Other cases, however, demonstrate that issues of improper fee-sharing can become more complicated. Depending on the circumstances, sharing of compensation may be allowed. For example, in *In re Statewide Pools, Inc.*, the trustee sought appointment of special counsel to pursue certain debts of the estate. 79 B.R. 312 (Bankr. S.D. Ohio 1987). Under the proposed agreement, the special counsel would pay a former officer of the debtor for assistance in collecting some of the debtor's accounts receivable. *Id.* at 313. The bankruptcy court held that the proposed arrangement did not constitute impermissible fee-sharing because the former officer had knowledge of the debtor's products and sales practices which might be valuable to

the special counsel, and because the officer was to be paid by the special counsel on an hourly basis. *Id.* at 315–16.

Issues involving fee-sharing may also arise in the context of non-professionals. While section 504 generally applies to professionals, the prohibition against fee-sharing may also extend to non-professionals, depending on the circumstances. *See* 4 COLLIER ON BANKRUPTCY, ¶ 504, at 504–7 (Alan N. Resnick et al. eds., 14th ed. rev. 2007). As a general matter, if the retention of the non-professional would not have required court approval under section 327 and the sharing is for services actually provided by the non-professional, expanding the prohibition to the non-professional would not accomplish any of the purposes of section 504. *Id.* Recent bankruptcy court decisions have noted that an attorney may not share fees with a paralegal completing a debtor's schedules, but may share with a paralegal assisting in the preparation of the schedules under the attorney's supervision. *Id.* For example, in *In re Tarasiak*, the court denied a fee sharing arrangement with paralegal functioning as a professional. 280 B.R. 791, 793 (Bankr. D. Mass. 2002).

Other courts, however, have found no improper fee-sharing in the context of non-professionals. For example, in *In re Van Dyke*, the bankruptcy court allowed the sharing of fees with a paralegal that was not a professional, and worked under attorney supervision. 296 B.R. 591, 595–96 (Bankr. D. Mass. 2003). The court noted that when compensation is sought for paralegals' services under section 329 or section 330, the work done must be itemized in detail and the rate charged must be justified. *Id.* at 595 (citing *In re Castorena*, 270 B.R. 504, 519 (Bankr. D. Idaho 2001)). Moreover, courts have held that services rendered by a professional may even be excluded from the prohibition against fee-sharing if the services themselves were not professional in nature. For example, in *In re Warner*, the court found no violation of section

504 where outside counsel was compensated for the cost of performing the administrative task of serving a subpoena, as the arrangement to pay the outside attorney was merely a payment for a necessary service. 141 B.R. 762, 765–66 (M.D. Fla. 1992). The court there noted that section 504 would not be applicable where the subpoena could have been obtained and served by a non-attorney, and that the compensation given to the retained counsel *did not contravene the purposes of Congress*. *Id.* at 766 (emphasis added).

III. Proposed "Hedge" Agreement is Denied in *In re Winstar*: Why the Court Got it Wrong

The proposed hedge agreement in *In re Winstar*, which would have given the attorneys downside protection against risks associated with appeal, should not have been deemed impermissible fee-sharing under section 504. Turning to the facts of the case, the Chapter 7 Trustee retained Herrick Feinstein LLP (hereinafter "Herrick") as special litigation counsel to represent the Trustee in a pending adversary proceeding. Later, the court authorized the Trustee's employment of Impala Partners, LLC (hereinafter "Impala") as special litigation consultant. On April 7, 2007, Herrick and Impala filed a motion seeking the court's permission to assign part of their anticipated contingency fees to Credit Suisse Loan Funding LLC (hereinafter "CS"). Under the proposed agreement, CS agreed to pay an undisclosed fixed price to Herrick and Impala, regardless of the amount of contingency fees awarded. In exchange, CS would receive from Herrick and Impala the actual amount of contingency fees awarded, up to $10,000,000.00. If the actual fees were awarded were less than $10,000,000.00, Herrick and Impala would keep the undisclosed fixed price and pay CS any fees awarded by the court. If the actual fees were to exceed $10,000,000.00, Herrick and Impala would share the fees in excess of

$10,000,000.00 in accordance with their respective, court-approved retention agreements. Additionally, in order to assure the Chapter 7 Trustee of their loyalty, the proposed agreement included a provision stating that CS has no right to object to the Trustee's settlement or other disposition of the adversary proceeding. The U.S. Trustee objected to the motion, claiming that the proposed agreement violated the Bankruptcy Code's prohibition of fee-sharing. The bankruptcy court agreed with the U.S. Trustee, and denied the motion without prejudice. *In re Winstar*, 378 B.R. at 761.

The rationale of the *In re Winstar* decision deserves considerable attention, as the court conceded that the proposed transaction did not appear to offend the policy considerations underlying section 504. *Id.* In asserting that section 504 was not violated because the agreement is consistent with the policies that section 504 was promulgated to advance, Herrick and Impala made two arguments. First, Herrick and Impala argued that they had no incentive to inflate fees because the fees have already been earned. The parties had agreed in advance that compensation associated with the appeal will be calculated separately from the fees earned in the adversary proceeding. Second, they argued that CS could not exercise undue influence on Herrick and Impala because CS specifically agreed that it has no right to object to any settlement. *Id.* at 760. Although the court stated that it did not disagree with Herrick and Impala, and even recognized that estate professionals may develop creative methods to attract and support law firms that undertake complex expensive litigation on behalf of the debtor's estate to provide "downside" protection, the court failed to recognize this "novel and unfamiliar financing transaction" (as it was described by Herrick and Impala), as a valid arrangement. *Id.* at 761. Just as the court in *In re Warner*, discussed in Part II above, found no violation of section 504 where the compensation given to the retained counsel in that case did not contravene the purposes of the statute, 141 B.R.

at 766, the court in *In re Winstar* would have been justified in allowing Herrick and Impala to enter into the hedge agreement when clearly the policies of section 504 were not offended.

Furthermore, the court's discussion on statutory interpretation is also noteworthy, as the court's plain meaning approach underlies the difficulty that estate professionals have in developing such "creative" financing arrangements. The court reasoned that because it found no ambiguity in section 504, specifically in the term "share," the court must apply the statute as it is written. *Id.* The court noted that "'if the statutory language is unambiguous and the statutory scheme is coherent and consistent . . .,' the inquiry must end there." *Id.* (citing *In re Telegroup, Inc.*, 281 F.3d 133, 137 (3d Cir. 2002), quoting *Robinson v. Shell Oil Co.*, 519 U.S. 337, 340 (1997)). Giving the term "share" its plain meaning, the court defined the verb as "to divide and distribute in shares: apportion" and "to grant or give a share in . . . ." *Id.* (citing Merriam-Webster Online, *available at* http://www.merriam-webster.com). The court's strict adherence to the language of the Code, despite the court's admission that section 504's policy considerations were not offended in this case, implies that attorneys may not be able develop appropriate strategies to obtain downside protection against risks associated with appeal. As a result, estate professionals will have difficulty attracting and supporting law firms that undertake complex expensive litigation on behalf of the debtor's estate.

Moreover, the court's contentions that the proposed agreement, by its terms, indisputably "apportions" any award of fees to Herrick and Impala with CS, and that the proposed agreement provides that Herrick and Impala will "grant or give [to CS] a share in" any contingency fees awarded, are not sufficient to hold that the proposed agreement constitutes impermissible fee-sharing under section 504 in this case. As noted earlier in Part II, courts have recognized that sharing of compensation may be allowed, depending on the circumstances, particularly in the

area of non-professionals, where the purposes of section 504 are not accomplished. Just as the court in *In re Van Dyke* found that attorneys may contract out work to paralegals who were not professionals under the circumstances, 296 B.R. at 595–96, the *In re Winstar* court would have been justified in allowing Herrick and Impala to contract out the risks associated with appeal to financial lending institutions such as CS, who are arguably non-professional.

CONCLUSION

As a matter of policy, the *In re Winstar* court should have allowed the proposed hedge agreement. While the overall goal of preserving the integrity of the bankruptcy process is recognized by judges, practitioners, and scholars, this goal was in no way disturbed by the proposed hedge agreement in this case. This decision implies that attorneys seeking fee arrangements protecting against risks associated with litigation will have to overcome the hurdle of the bankruptcy courts' strict adherence to the language of the Code. It remains to be seen if there are any strategies available that are creative enough to overcome this hurdle.